Electronic Tax Administration Advisory Committee

Annual Report to Congress

June 19, 2008

Contents

PURPOSE OF ETAAC

The Restructuring and Reform Act of 1998 (RRA 98) created the Electronic Tax Administration Advisory Committee (ETAAC) for the purpose of providing feedback to the Internal Revenue Service (IRS) on the development and implementation of their electronic tax administration strategy. Specifically, ETAAC provides an ongoing public forum for the discussion of electronic tax issues, especially as it relates to the electronic filing (e-filing) of returns.

DUTIES OF ETAAC

According to its charter, the ETAAC's duties are to research, analyze, consider and make recommendations on a wide range of electronic tax administration issues and to provide input into the development and implementation of the strategic plan for electronic tax administration. As required by RRA 98, the ETAAC shall report annually to the Congress on:

(1) The progress of the IRS in meeting the goal of receiving electronically 80 percent of tax and information returns;

(2) The status of the strategic plan for electronic tax administration;

(3) The legislative changes necessary to assist the IRS in meeting such goal; and

(4) The effects on small businesses and the self-employed of electronically filing tax and information returns.

The IRS Oversight Board shares a similar reporting responsibility. Among its responsibilities, the Board evaluates all that the IRS does from an electronic tax administration perspective to fully modernize the IRS. We encourage readers to review the Board's Electronic Filing 2007 Annual Report (February 2008) for additional insight.

2008 ETAAC Membership

Chris Beach
Dir. of Filing Methods
CA Franchise Tax Bd.

11/2006 – 11/2009

Grant F. DeMeritte
Tax Compliance Mgr.
Howard Hughes
Medical Institute
12/2007 – 12/2010

Brian Digman
CIO
NY Tax & Finance

12/2007 – 12/2010

Larry Dreyer
Retired
Bank of America

09/2005 – 09/2008

Susan Gaston
Dir Industry Operations
H&R Block

12/2007 – 12/2010

Sharon S. Gray
CPA
Self Employed
11/2006 – 11/2009

Tim Hubbs, Chairman
President & CEO
Drake Software
11/2006 – 11/2009

James A. Huling
Senior VP
JP Morgan Chase
09/2005 – 09/2008

Roberto Jimenez-Ortiz
Advisor
World Bank
12/2007 – 12/2010

William Marshall III
EA & Member Mgr.
Marshall & Assoc.
12/2007 – 12/2010

Robert Meighan
VP, Turbo Tax
Intuit
09/2005 – 09/2008

Joan R. Ruff
Attorney

11/2006 – 11/2009

Ryan L. Snow
CFO
Burdick Paving
12/2007 – 12/2010

Anthony T. Tullo
Dir. of Fed. Compliance
ADP
09/2005 – 09/2008

INTRODUCTION

ETAAC members represent a broad cross-section of the electronic tax filing and IRS systems modernization communities. ETAAC members include CPAs, EAs, CFOs, key managers from states, an attorney, executives from payroll and tax software companies (on-line, retail and preparer), a small practitioner, a large tax preparation chain, financial institutions, and one bank offering refund-related bank products.

The IRS is approaching an unprecedented time in its history:
- The IRS has several key form types that have not reached the 80% e-file penetration goal and will not anytime in the near future without creating a catalyst for change.
- In the next four years, the IRS will be retiring many of its legacy systems and performing final implementations on new ones. This could very well be one of the largest computer conversions in history.
- Many have questioned the suitability and competency of Electronic Return Originators (EROs) and paid preparers.
- The IRS is bringing more options for taxpayers to the web, which affords the IRS the ability to save money through technology while providing improved services to taxpayers.

Recommendations on all of these issues are provided in this report. No recommendation included in this report is the opinion of a single member, but rather a consensus reached by the committee. Additionally, the ETAAC members determined that none of the recommendations herein would have a substantial impact on small business or the self-employed.

IRS E-FILING PROGRESS

In RRA 98 Congress established the goal that, by 2007, 80% of all returns should be filed electronically. In its review of e-filing progress and its recommendations to increase e-filing, ETAAC has reviewed both tax returns and information returns. To ensure focus on recommendations that will have the biggest impact on electronic filing, ETAAC has limited its review of return types to those that have at least one million in annual volume and less than a 99% e-file penetration (most information returns have more than a 99% e-file penetration).

In spite of late tax legislation and the introduction of the Economic Stimulus Act, the IRS' extraordinary efforts helped in delivering a successful 2008 tax season. The AMT and related tax legislation delayed the completion and filing of millions of returns with heavy filing toward the end of the season. According to the IRS, 143.1 million Individual returns (paper and electronic) were received by the IRS as of May 16, 2008, which is 10.8% more than were received as of the same date in 2007. Some of the increase in returns is due to taxpayers who normally would not be required to file but did so in order to receive economic stimulus payments. Individual returns that were received electronically as of this date totaled more than 86.3 million, which is a 12.0% increase over the prior year as of this date, and is 60.3% of the total Individual returns received. The electronic return penetration in the prior year at this same time was slightly less at 59.7%. The impact that the Economic Stimulus returns had on these statistics has not been fully determined; however, it is clear that there continues to be a wide gap between the current electronic filing penetration and the 80% goal.

It is also worthy to note that the IRS Customer Account Data Engine (CADE) processed more than 30 million individual returns as of mid-May, which is more than double the number of returns handled by the

system all of last year. CADE is at the heart of efforts to replace many of the agency's aging tax administration account processing systems and processes refunds on average five days faster than the legacy system.

From IRS sources as of May 29, 2008, other positive news includes the year-over-year increases of 19% in on-line returns, 21% in Balance Due returns, 37% in Electronic Payments and 23% in Free File Alliance returns.

Again, we commend the IRS for meeting the dual challenges from late tax legislation and stimulus payment processing. We believe that in the future late tax law changes will be the norm rather than the exception, and ETAAC is concerned with the IRS' capacity to sustain this year's extraordinary efforts year after year. We, therefore, encourage the IRS to examine their operations with an eye to its ability to fund, resource and execute on late legislation.

Chart 1 shows the progress for Form 1040 returns from calendar year 1998 through 2008.
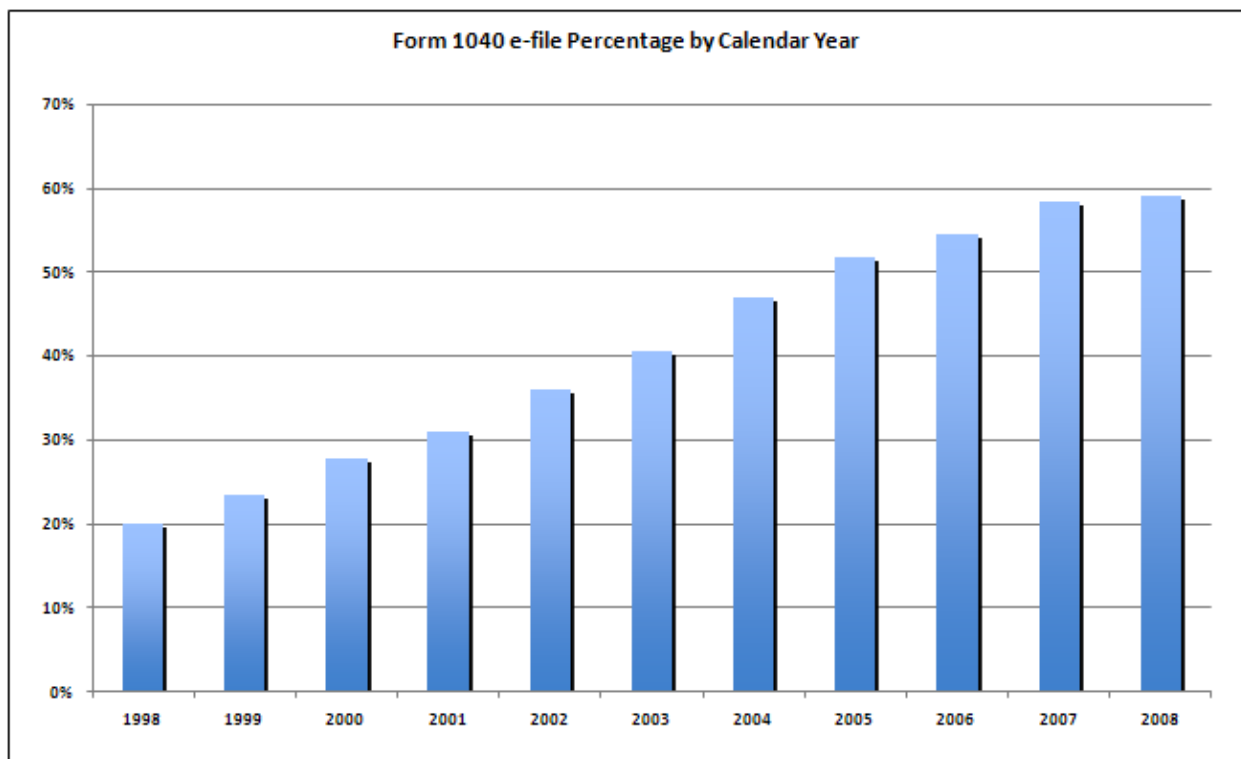

Chart 1: Form 1040 e-file Percentage by Calendar Year. Source: 1998-2005 data per SOI Bulletin Historical Table 21. 2006-2007 data per Document 6186 (CY 2007-2014). 2008 data projected by ETAAC based on Document 6186 combined with interim data released by the IRS as of May 16, 2008 and considering some impact of returns filed due to economic stimulus payments.

Steady e-filing increases have been made for 1040 returns and other tax form types. However, a great deal remains to be achieved as indicated by the following Chart 2, which depicts the percentage of the annual total return volume of the returns being reviewed and the e-file penetration percentage of each of the respective forms.

Calendar Year 2008 Projected Return Filings

■ % of Total Tax Return Volume   ■ % E-Filed

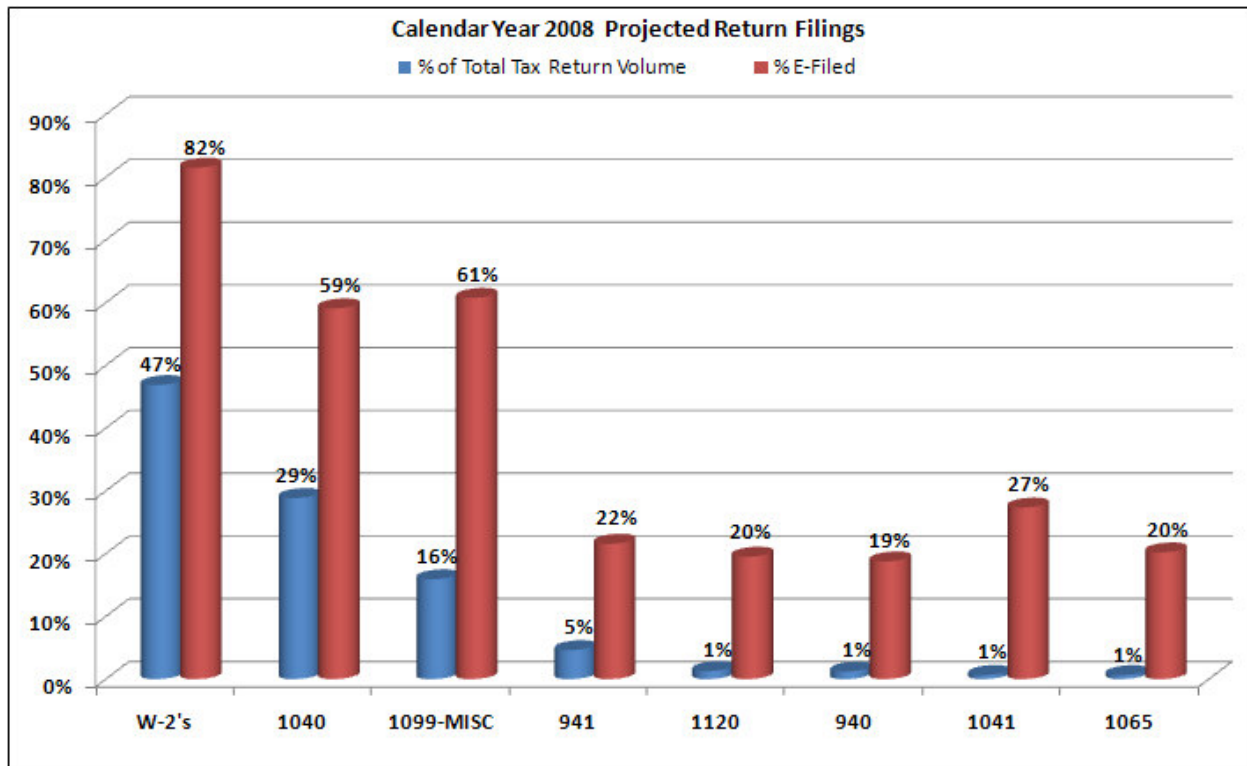| Form	% of Total Tax Return Volume	% E-Filed
W-2's	47%	82%
1040	29%	59%
1099-MISC	16%	61%
941	5%	22%
1120	1%	20%
940	1%	19%
1041	1%	27%
1065	1%	20%

Chart 2: Projected Individual Return Filings for Calendar Year 2008 (2007 Returns). Source: Projected tax returns for 2008 per IRS SOI Document 6186 (Revised 12-2007), IRS 2008 Interim Stats for 1040 Returns as of 5/18/2008 and ETAAC projections based on this data and some consideration of volume related to additional returns filed due to the economic stimulus payment initiative.

All tax form types are important in achieving the established 80% e-file goal. However, ETAAC believes that the IRS' greatest opportunity for improvement lies with the return types that have the largest volume, specifically the Form 1040 series (Individual Tax Returns), Form 941 (Employer's Quarterly Federal Tax Return), Form W-2 (Wage and Tax Statement) and Form 1099-MISC (Miscellaneous Income).

INDIVIDUAL RETURNS

The IRS Oversight Board, in its Annual Report of 2007, dated February 2008, approved extending the 80% e-file participation goal for "major tax forms" to 2012. The Oversight Board also stated that, in its opinion, the IRS must exhaust all reasonable steps to maximize voluntary participation in individual e-file before imposing any mandates on preparers as suggested in the 2007 ETAAC report.

E-filing is not a new concept. The e-filing option has been available for 1040 returns on a national basis for almost two decades. During that time, the IRS has expended enormous time and resources for taxpayer, tax preparer and other third party education on the advantages of electronic filing. The IRS has also worked with states to ensure that state returns could be filed with the Federal return, making e-filing more efficient for taxpayers and processing easier for states.

E-filing is simple and inexpensive. Virtually all software packages available today provide the ability to e-file individual tax returns with little effort and no additional equipment or systems required other than an Internet connection. Many practitioner software packages either do not charge an extra fee or charge a nominal fee for e-filing a return. In 2007, tax preparers using software completed over twenty-three

million returns and had the taxpayer paper file them, even though they could have easily been e-filed. According to the Taxpayer Assistance Blueprint, taxpayers who use a paid preparer but file a paper return do so not because they are opposed to e-filing but because the preparer had not recommended e-filing as an alternative.

Large stakeholders support and champion e-filing. National tax preparer organizations have been recommending e-filing for many years. Professional associations have also been recommending e-filing to their members. For example, as far back as November 2002, the American Institute of Certified Public Accountants publicly supported e-file by its inclusion of the article "It's Time to E-File" in its monthly publication, Journal of Accountancy. This article discussed the benefits of e-filing and stated that "CPAs can no longer postpone signing up for the IRS electronic filing program".

Based on trends and current practices, without mandates the IRS will fall short of the 80% goal for Form 1040s whether or not that goal is extended to 2012. The Government Accountability Office (GAO) supports a mandate for e-filing. It appears that many existing preparers who do not electronically file eligible returns are waiting for government to require or mandate e-filing. States that have preparer mandates indicate little negative feedback received from preparers related to the mandates.

Preparer Mandates

At this time, ETAAC believes that all reasonable voluntary means have been exhausted with respect to encouraging preparers to e-file Individual Tax Returns, and it is time to take a stance by announcing an e-file mandate for tax return preparers. Although ETAAC believes that mandates provide the single biggest opportunity for the IRS to increase e-filing rates, there must be exceptions that recognize situations where e-filing may not be practical or possible. These exceptions might include non-software prepared returns, ineligible returns and taxpayer preference. An information gathering or opt-out process would also allow the IRS to see where e-file resistance occurs and be able to act accordingly to issues raised.

1. ETAAC recommends that Congress empower the IRS to require paid preparers who, using tax software, prepare more than fifty individual returns per year to file all returns electronically. This requirement should be buffered by allowing waivers, minimum penalties for non-compliance, and appropriate opt-out provisions. This recommendation was made by the ETAAC in 2007.

Parity Between Paper & E-File Methodologies

More than 10% of individual returns electronically filed to the IRS are rejected by IRS systems for a host of reasons. Below are examples of the most common rejects:
1. Dependent's Social Security Number (SSN) was previously used on another current year return
2. Taxpayer's SSN does not match name per Social Security Administration (SSA) records
3. Taxpayer's or Spouse's SSN was used as a dependent on another current year return
4. Qualifying SSN on Schedule Earned Income Credit (EIC) was used on another current year return
5. Dependent SSN does not match name per SSA

It saves a great deal of time and money for taxpayers, preparers and the IRS to resolve these return problems prior to acceptance by the IRS. The majority of rejects are resolved in this manner; however, there are times when the taxpayer will have a position that the return is correct, even though it rejects on the IRS systems. Even though the taxpayer believes his/her return is accurate, he/she is not able to file the

return electronically, which forces the taxpayer to print and mail it. The IRS then must open it and key the return, and the issue that prompted the original reject will still have to be resolved.

A few years ago, the IRS allowed returns with two specific rejects to be e-filed without resolving the reject by including an "imperfect return indicator" to override the error within the electronic return. This does not solve the problem, but it does allow for additional parity between paper and electronic returns. On most remaining rejects, if the taxpayer feels that the return is correct, the taxpayer must file the return by paper, thus delaying the processing and error resolution of the return as well as costing everyone involved additional time.

2. ETAAC recommends that e-filed returns should have more parity with paper returns. There should be additional opportunities to e-file returns that would normally be filed on paper when the return reject is known to be in error. As such, if a return has been rejected previously for something other than a math or format error, then the IRS should allow the taxpayer to provide an explanation in the electronic record and request to submit the return electronically with an imperfect return indicator. This would prevent the return from having to be paper filed, hand keyed by the IRS and the resolution of the problem from being delayed.

Fees for E-filing

According to the IRS over 36 million returns were prepared on computers but were filed on paper in calendar year 2007, with over 35% of these being self prepared. When a taxpayer prepares his/her own return or has it prepared by a third party and the option of filing the return electronically is more expensive than filing it by paper, it is the National Taxpayer Advocate's position and the position of the ETAAC that a significant number of these taxpayers will elect to file by paper, thus limiting e-file penetration.

3. ETAAC recommends that the IRS strongly encourage transmitters, software providers, on-line providers and preparers to eliminate fees for electronic filing, so as to not discourage the selection of the e-file option.

QUARTERLY EMPLOYMENT TAX RETURN (FORM 941)

As indicated in the 2007 Update of IRS SOI Document 6186, it is expected that 23.9 million Forms 941 will be filed in 2008 with over 18.8 million (78%) being filed on paper. There is no appropriate free solution for e-filing Form 941 as there is with the Free File Alliance for 1040 returns. There is no incentive for businesses to e-file Forms 941 as there is with accelerated refunds on Form 1040. As evidenced by the 22% e-file penetration rate, online acknowledgements and more accurate returns do not provide sufficient incentives to e-file Form 941.

4. ETAAC recommends that the IRS develop a free online filing solution for employers to input and e-file their Employer's Quarterly Federal Tax Return, Form 941. ETAAC has identified three possible approaches: IRS develops, implements, and maintains a 941 e-file solution; IRS contracts out the development of a 941 e-file solution; or IRS negotiates a similar solution to the Free File Alliance program with third party vendors.

5. ETAAC recommends that employers who are required to e-file their W-2s electronically also be mandated to e-file their Forms 941. This recommendation was made by the ETAAC in 2007.

REPORTING AGENTS AND EFTPS

Revenue Procedure 2007-38 currently requires Reporting Agents to e-file all employment and unemployment tax returns where there is an e-file option. Reporting Agents are only required to use the Electronic Federal Tax Payment System (EFTPS) to deposit taxes for their clients who the IRS has mandated to deposit by Electronic Funds Transfer (EFT).

There are approximately 5,000 Reporting Agents (RAs) on the IRS Reporting Agent File. The IRS should consider revising Revenue Procedure 2007-38 to require that RAs submit all clients' Federal Tax Deposits (FTD) via EFTPS. The IRS currently receives in excess of 50 million FTD paper coupons each year. Having RAs submit FTDs electronically will help reduce this paper volume. With this approach, the mandate is not directed at the employer level but rather at the Reporting Agent level.

To complement this change, the IRS should further direct RAs to advise their clients to enroll in EFTPS to monitor whether the deposits are being made timely. EFTPS allows enrolled users to view deposit activity daily. This will assist the taxpayer in staying current with their deposit obligations. This also has the potential to make a positive impact on the tax gap, as the employer has an automated means of identifying compliance problems before penalties are assessed and notices issued.

6.   ETAAC recommends that Reporting Agents, who file employment and unemployment returns for others, be required to submit payments electronically via EFTPS.

INFORMATION RETURNS

The 2008 e-file rates for Information Returns are similar to the prior year. Only the Forms W-2 and 1099-Misc have significant paper submissions and as such are the only ones included in Chart 2 on page 6. All other Information returns are at or nearing 100% e-file penetration.

W-2s are filed by employers with the SSA. Businesses that file more than 250 W-2s annually are required to electronically file in accordance with the Revenue Reconciliation Act of 1989 (RRA 89). The SSA provides a website to allow small businesses to key in W-2s so that they can be received electronically by the SSA. The mandate level was implemented nineteen years ago, yet the SSA still receives 45 million wage statements on paper each year.   If the mandate level on W-2 returns were lowered, the increase in e-filing rates would be significant while the burden on small business would be modest.

The following chart indicates the filing method used for submitting W-2s from 2000 through 2007. It is noteworthy that the percent of returns being filed by paper has been gradually reduced over this time period and the W-2s being filed by Magnetic Tape, Disk and CD have all successfully been converted to e-file.
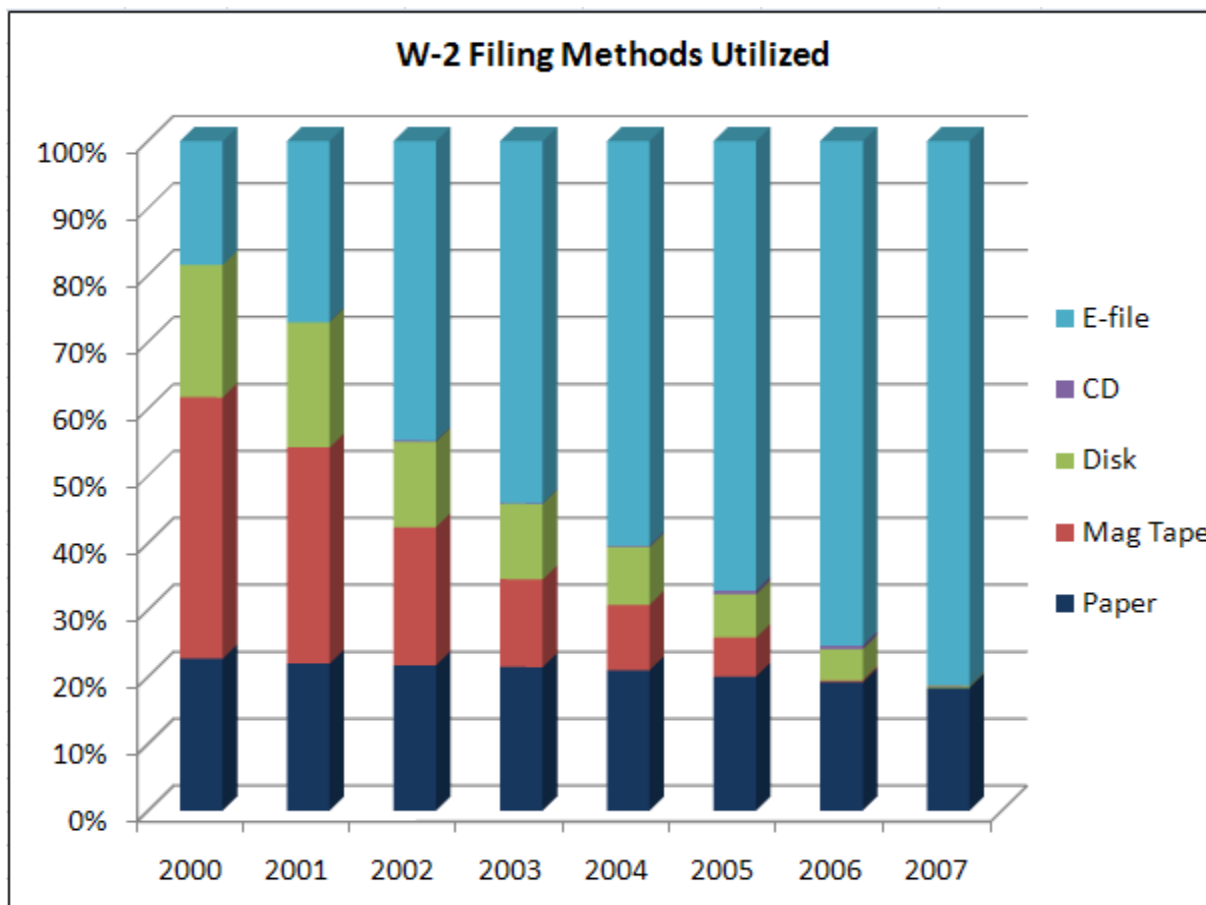
Chart 3: Methods Used to File Wage and Tax Statements. Source: Social Security Administration

ETAAC believes that with SSA's investment in providing a free online tool for employers, the availability of commercial programs to file W-2s electronically, the nineteen year period since the last mandate was implemented, and the 45 million W-2s that are still being filed by paper, it is time to aggressively increase the number of employers who are required to file electronically.

7. ETAAC recommends that the mandate threshold for filing W-2s electronically be decreased. The appropriate level should be based upon input from SSA on the affect of mandates on their W-2 website utilization and the threshold level needed to eliminate the majority of the 45 million paper W-2 filings. It is our understanding that Congress must authorize the change in this mandate. This recommendation was made by the ETAAC in 2007.

Over 82 million Forms 1099-MISC (Miscellaneous Income) are filed on an annual basis with over 32 million being filed by paper. The only electronic mandate for this form was set by RRA 89, which mandated e-file for those that filed more than 250 of these forms annually. The real opportunity for significantly increasing e-filing lies with those businesses that file fewer than 25 statements, since that is where the majority of the 32 million paper-filed returns originate. There are commercially available products that allow for filing Form 1099-MISC electronically, but there is no current free method available, and the number of impacted businesses affected is very small. As such, before the mandate is lowered for Form 1099-MISC, the barriers to e-filing should be reduced.

8. ETAAC recommends that the IRS develop an online process to upload data electronically for inputting and e-filing Forms 1099-MISC, similar to the functionality provided by the SSA that allows W-2s to be electronically submitted. This recommendation was made by the ETAAC in 2007.

MODERNIZED *E-FILE*

The IRS has an ongoing commitment to modernize its e-file systems. ETAAC has previously acknowledged the value of this initiative and recognizes the significant progress the IRS has made as to the nearly complete business e-file modernization.

Following the IRS' successful implementation of modernized e-file for businesses, Form 1040 modernization (1040 MeF) is preliminarily scheduled for release beginning in August, 2009 as outlined in the chart below. Beginning January 2013, all individual e-filed returns are scheduled to be submitted via the 1040 MeF system.

1040 Modernized e-File (MeF) Implementation Timeline

Phase I Part 1	Phase I Part 2	Phase II	Phase III	Discontinue Legacy	MeF Only
Aug 2009	*Jan 2010*	*Jan 2011*	*Jan 2012*	***Oct 2012***	*Jan 2013*
2008 Tax Year	*2009 Tax Year*	*2010 Tax Year*	*2011 Tax Year*		*2012 Tax Year*
Form 1040 and 21 forms	Same forms	Additional forms and schedules	All forms and schedules		All forms and schedules

The impact of modernized e-file conversion on the individual income tax e-file ecosystem, including the IRS, states, developers, transmitters, practitioners, and taxpayers, is significant. In many ways it will completely alter how the ecosystem functions. Business e-file largely introduced a new system where one had not previously existed. On the other hand, 1040 MeF will completely change an existing e-file platform that has been in use, nationwide, for eighteen years. In fact, between the IRS and the states, it is estimated that in 2008 almost 200 million individual income tax returns will be e-filed using systems and processes that will be fully retired in just a few years. By the time that MeF is fully implemented, up to a quarter of a billion individual income tax returns may be affected.

Given the impact of 1040 MeF on the IRS and national stakeholders, ETAAC believes there are three criticalities to successful 1040 MeF implementation.

Meeting 1040 MeF Milestones

Modernized e-file for individual taxpayers is critical and has long been a priority on the list of major IRS modernization efforts. Full 1040 MeF implementation is expected to provide important benefits to all members of the e-file stakeholder community. However, the overall financial impact of 1040 MeF development and implementation on stakeholders is material. With the IRS' planned phase-out of its

legacy e-file system in late 2012, MeF leaves no alternatives for stakeholders as to when or how extensively they get involved.

Keeping the 1040 MeF project on schedule and meeting major milestones will be paramount to successful implementation. Any delays or missed milestones will have ripple effects throughout the stakeholder community as they will have to adjust scheduling and resources and to account for contingencies relating to the phase-out of their own legacy systems. Running concurrent e-file systems longer than necessary is costly and ultimately erodes benefits associated with the modernized effort. Running concurrent systems also injects added risk into the IRS' technical environment that could affect systems and processes feeding into and out of the e-file domain. As a result, any delays in meeting key milestones could have significant national implications, including the inability to file returns due to incompatible systems.

The IRS is currently planning for a three-phased approach to 1040 MeF implementation. This approach breaks up the availability of approximately 150 forms and schedules over a three-year period, ending with all forms being available by January 2012. Discontinuance of their legacy system is scheduled for one year later, by January 2013. The IRS has previously weighed alternatives to the three-phased approach, including a condensed two-phased timeline that would shave off one year of the legacy phase-out. To reduce the risk to the IRS and stakeholders of prolonging the maintenance of dual systems, ETAAC strongly supports finding an alternative that can effectively result in termination of the legacy system by January 2012.

9. ETAAC recommends that the 1040 MeF project and related funding continue to be considered mission critical by Congress and the IRS' overseers. In this spirit, ETAAC recommends that:
   - Funding and resources be made available to support an implementation timeline that results in the availability of all 1040 form types by January 2011, and the termination of the IRS's legacy system by 2012.
   - For the implementation date that is ultimately determined, major milestones are reasonably established and met with minimal interruption to the final date.
   - In the event of cost over-runs or budget realignments, there must be viable, pre-determined contingency funding plans that can be quickly and efficiently executed.

1040 MeF Availability

The 1040 will be the most complex release within the modernized e-file platform, with numerous system interfaces and dependencies. As with any major system implementation, availability and performance are at significant risk. For successful implementation there are critical issues that must be addressed and managed beyond the development of the 1040 MeF system, such as system redundancy and failover, 24/7 availability, sufficient throughput, effective integration of systems, and adequate system/customer support. More than 200 million taxpayers and their supporting stakeholders will be relying on the MeF system. They have a right to expect that its performance, availability and support will be superior to the legacy system.

From an overall development perspective, the currently scheduled August 2009 Phase I implementation is a critical date. The appropriate infrastructure such as hardware, software, interfaces and system engineering must be fully in place for all phases before Phase I goes live. Core incremental additions and improvements to the infrastructure between phases would increase 1040 MeF performance risks while adding further complexities that could be avoided with complete upfront integration and support.

10. ETAAC recommends that 1040 MeF system integration, availability, performance and support issues be clearly addressed and solutions identified and in place before Phase I goes live.

Communications to Stakeholders

Discontinuance of the IRS' legacy e-file system is only four years away. It is, therefore, paramount that all stakeholders are well-educated, understand the timelines and are ready for 1040 MeF implementation according to the IRS schedule. The IRS has done a commendable job collaborating and communicating with interested software developers, states and tax practitioners via many separate forums. In spite of these commendable efforts, there will likely be a significant gap in comprehension and performance between those stakeholders who have taken the initiative to get involved with 1040 MeF development and those stakeholders who have not been involved but will ultimately need to be. If this gap is not addressed in a comprehensive way, large pockets of the e-file ecosystem will be scrambling to accommodate implementation in the end. Given the complexity of 1040 MeF development, this gap could pose material risks to 1040 MeF implementation, at both the IRS and individual stakeholder levels.

In ETAAC's collective experiences, it is important that communications, stakeholder inputs and change management all be handled from a central point that all stakeholders can access for reliable and up-to-date information. The separate collaborative efforts currently occurring among various stakeholder groups can easily leave critical aspects of development and implementation unaddressed among those stakeholders who are not a part of or privy to the current efforts.

11. ETAAC acknowledges that the IRS is in the process of completing a 1040 MeF communication plan. ETAAC recommends that such a plan include stakeholder representation from all affected segments of 1040 MeF implementation and broadly address change management including:
    - Stakeholder communication needs assessment and consequent action plan,
    - Risk mitigation, and
    - Accounting of stakeholder readiness

ELECTRONIC RETURN ORIGINATOR SUITABILITY

There were 259,009 Electronic Return Originators (EROs) as of May 22, 2007, who e-filed 55 million (71%) of the 77.1 million e-filed returns accepted in 2007. Members of the U.S. Congress, the National Taxpayer Advocate, U.S. Treasury Inspector General for Tax Administration (TIGTA) and consumer advocate groups have, in recent years, questioned the suitability, integrity and competency of some EROs. Because the ERO population is a critical component of the e-file system, taxpayers should be able to rely on EROs to have met some reasonable minimum requirements before IRS acceptance as an ERO. ETAAC believes strongly that procedures should be implemented as soon as possible to ensure EROs meet and maintain certain minimum standards of integrity, suitability and competence.

Current IRS suitability and oversight processes are designed to encourage participation in support of the 80% goal and consequently, there are very few barriers to obtaining and maintaining an EFIN number and continuing participation in the program. In addition to the recommendations that are outlined below, ETAAC recommends that the IRS re-focus the overall objective with a risk management approach instead of a marketing approach. Minimization of high risk applicants will reduce the incidence of fraudulent return filing, will protect the taxpaying public, and will instill a higher level of integrity into the e-file process. Using proper risk management techniques throughout all stages of the process will more than pay

for any incremental implementation costs and will likely save hundreds of millions of dollars of refunds that should not be paid.

12. ETAAC realizes that some of the recommendations in this section will require additional costs and resources to implement. ETAAC recommends that EROs and tax preparers be assessed an annual fee to fund these costs.

Application Process

To participate in the IRS e-file program, a prospective ERO must submit an e-file application. Currently the e-file application can be submitted electronically through e-Services or by mailing Form 8633, Application to Participate in the IRS e-file Program, to the IRS. Over the last three years, the IRS has received, on average, approximately 27,000 new ERO applications each year. Approximately 50% of the applications are received electronically. The IRS matches the Name, SSN, and Date of Birth of all Principals and Responsible Officials shown on the applications with Social Security Administration records. To submit electronic applications, individuals must first register for e-Services, which authenticates the identity of the individuals by requiring each individual to submit his or her prior year or current year Adjusted Gross Income and matching it with IRS records. ETAAC believes that electronic and paper applications should have consistent standards and those standards should be in line with making interactions digital.

13. ETAAC recommends that all e-file applications be submitted electronically through IRS e-Services and that paper applications be eliminated.

Effective October 1, 2007, the reasons for denial of participation in IRS e-file and for sanctioning were updated to include an indictment or conviction of any criminal offense under the laws of the United States or of a state or other political subdivision, or an active IRS criminal investigation. Currently 25% of applicants (excluding Circular 230 practitioners, certain banking officials, and officials of publicly traded companies) who submit applications undergo criminal background checks. IRS estimates that one to three percent of the applicants screened through this process are declined for participation in the program. This percentage seems to be sufficient indication that the process is warranted. On average, 4,000 individuals have been subjected to the criminal background check in each of the past three years. An estimated 16,000 individuals would be subject to the criminal background check each year if a check was performed on all new individuals (excluding Circular 230 practitioners, certain banking officials, and officials of publicly traded companies). If the midpoint in this range (2%) is applied to the 48,000 individuals over the past three years, there would have been 960 individuals denied participation in the e-file program, while in fact only approximately one fourth of that number were actually denied. Thus, over 720 EROs became authorized e-file providers who should not have been.

14. ETAAC recommends that, to ensure the integrity of the e-file system and to enforce the importance of the new rule, criminal background checks are performed on all individuals required to submit fingerprints as part of an e-file application. This would not negate or be in lieu of any other requirements. This recommendation was made by the ETAAC in 2007.

According to banks that monitor EROs with regard to bank products and the individual tax returns associated with them, there is a high correlation between an individual's poor credit history and fraudulent tax return preparation -- demonstrated by high levels of unpaid refunds. Bank experience indicates that a credit bureau score cut-off would help to identify potential fraudulent preparers. ETAAC strongly believes that, beginning with the upcoming tax season, the IRS should perform credit checks on all Principles and Responsible Officials included on e-file applications (excluding Circular 230

practitioners, certain banking officials, and officials of publicly traded companies). While an automated process is preferable, the policy can be implemented in a manual review environment using desktop-purchased credit bureau data. The costs for a credit report, less than $1 per report, and an increased level of criminal background checks can be covered by an ERO application fee.

15. ETAAC recommends that ETA evaluate credit bureau data and establish a policy for determining acceptance/rejection of prospective ERO applicants using that data. This recommendation was made by the ETAAC in 2007.

ERO Monitoring

Integrity of the ERO program facilitates taxpayer confidence in e-filing; therefore, it is essential that the IRS monitor the ongoing competency and integrity of EROs. IRS internal procedures define how an ERO will be monitored once in the program. During the 2008 Filing Season, IRS made approximately 1,500 visits in the following four categories: referral, follow-up, targeted, and random. EROs with high reject rates (currently defined as 25%), those being investigated by another branch of the IRS such as Criminal Investigation, and/or high rates of suspicious returns should require additional scrutiny. This type of risk-based analysis is already being done with regard to EITC Due Diligence Visits, targeting preparers with patterns of EITC returns that appear to be suspicious. Random, on-site visits are not as efficient and, given current limited resources, do not provide the best return on investment.

IRS should analyze its risk tolerance for EROs and make appropriate objective standards. Certainly, any standards and monitoring process must include an appeal process or waivers that are determined on a case-by-case basis.

16. ETAAC recommends that more funding be provided for ERO monitoring visits. Until such funding is made available, the IRS should prioritize more heavily those visits that involve EROs who, through risk based analysis, appear to be jeopardizing the integrity of the system. This recommendation was made by the ETAAC in 2007.

ERO Oversight

IRS Wage & Investment Division is responsible for the oversight of EROs and the screening process while the IRS Small Business / Self Employed Division retains responsibility for the ERO monitoring program. Dividing responsibilities for ensuring the integrity and competency of EROs lessens overall accountability. If these responsibilities were combined under a single division, responsibilities could be implemented more effectively. This is especially true for EROs who have been suspended from the e-file program and attempt to get back into the program through an application submitted by a close relative or an associate. Additionally, when evaluating applications from companies who submit multiple applications for various locations or multiple applications for a single location, a better assessment of the appropriateness of such actions could be made if a single division had oversight of ERO applications and ERO monitoring.

17. ETAAC recommends that a single IRS division be responsible for both screening e-file applications and monitoring EROs to provide a consistent approach, improved oversight and full accountability. This recommendation was made by the ETAAC in 2007.

Paid Preparers

Currently anyone can hold themselves out as a tax preparer with no minimum requirements, testing or ongoing training being required. Completing tax returns is so complex and cumbersome to the average taxpayer that approximately 61% of all individual taxpayers are willing to pay a third party to prepare their returns. Because of this complexity and the trust placed in a preparer by a taxpayer, an untrained or unqualified person can inflict great harm on the integrity of the tax system. While the vast majority of third party preparers have a high degree of competence, there is a prevailing sense among ETAAC members and industry stakeholders that a significant number of individuals who lack the competency to prepare returns are, in fact, preparing returns for pay. ETAAC believes that bringing the existing non-licensed, paid tax preparers under the control of the IRS Office of Professional Responsibility (OPR) will give the IRS greater control and enforcement authority over this group. As an alternative, the IRS could utilize an outside entity structured similar to the National Association of Security Dealers.

18. ETAAC recommends that Congress and the IRS require testing and licensing of all non-Circular 230 tax preparers and that the IRS should be responsible for setting the requirements for competency levels and ongoing training. This recommendation should be implemented with input from stakeholders and over a two to three year period so as not to put an undue burden on tax preparation firms and not materially impact the availability of preparers to the taxpayer community. This recommendation was made by the ETAAC in 2007.

WEB SERVICES AND E-SERVICES

The IRS has tried many different approaches to increase voluntary adoption of electronic filing, including marketing and promotion of the Free File Alliance and trying to ensure there are fewer obstacles for participation in e-file. All have contributed in varying degrees of success to attracting more e-filers. However, no one initiative has been a panacea, but collectively they are making strides.

With an e-file adoption rate of 60%, the IRS needs to do more to attract additional e-filers. Today more than 97 million American taxpayers have access to free and convenient electronic filing through the Free File Alliance. While more than 4.6 million taxpayers used this service in 2008, the large number of taxpayers not taking advantage of the Free File Alliance suggests that something more needs to be done.

19. ETAAC recommends additional marketing of the Free File program. The program is already free and convenient. We believe additional marketing will drive awareness and ultimately adoption. Today, less than $2 million is devoted to promoting this program. Certainly, additional dollars will help increase e-filing numbers. This recommendation was made by the ETAAC in 2007.

Free File Alliance solutions are just one way to bring electronic tax preparation to the masses. ETAAC believes that increasing the number and quality of electronic services, especially ones that be used repeatedly throughout the year, can help further advance the adoption of electronic filing. The goal is to offer digital solutions that meet taxpayer needs (and not just tax filing solutions) so well that taxpayers can't imagine going back to the traditional ways of doing business with the IRS.

Introducing other electronic services not only brings the IRS further into the digital age, but more importantly, meets taxpayers' expectations consistent with existing industry solutions as e-commerce continues to grow rapidly. Digital solutions from the IRS need to solve important problems that taxpayers face from time-to-time and not just at tax time. For example, today when one books an airline reservation

online, the entire flight experience can be managed electronically. From ticketing, to seat assignment, to printing boarding passes, to resolving flight problems, passengers can and now expect to solve these issues entirely online. Similarly, many tax practitioners and their clients now interact totally digitally, from data capture/collection to return review. These types of activities are fueling demand from tax practitioners and taxpayers for additional digital services. Functionality comparable to what people expect in their dealing with their service providers and online merchants needs to be available to taxpayers in all their interactions with the IRS. It's all about making it an easier and more convenient experience with the IRS. When taxpayers have a better digital experience with the IRS, it is highly more likely they will be more willing to adopt e-filing when it comes to filing their return.

Certainly the IRS has made notable achievements in offering its stakeholders more digital services including timely news updates to subscribers, making their website (www.irs.gov) easier to use, introducing online support tools (AMT and EITC calculators), and supporting Multilanguage web sites.

20. ETAAC recommends the IRS accelerate the roll out of more digital services so taxpayers can engage electronically for all tax related activities. The IRS needs to map out the customer experience, end-to-end, to understand the types of solutions taxpayers require and then offer them digitally.

The IRS' MyIRSAccount is an important step in providing taxpayers more functionality and better access to their data. MyIRSAccount is envisioned to be a secure IRS website hosting tax documents such as past tax returns, IRS notices (like CP2000), and information returns. The goal of MyIRSAccount is to enable taxpayers to use self-service methods to gain access to tax documents without having to do so through the traditional IRS service channels (phone and letters). Many may choose the MyIRSAccount option; however, ETAAC believes taxpayers should be empowered to choose how they access and use their data without regard to MyIRSAccount. Specifically, the IRS should support access to a taxpayer's account through other commercially available software with which they are already comfortable. This is obviously predicated on preserving and honoring all security and privacy requirements that need to be met for MyIRSAccount. For example, similar to the airline example, a taxpayer or their tax practitioner may file using any number of commercial tax software packages. Subsequently, they may need to validate or query their IRS account information. They should be allowed to do this through the tax software they originally used, the IRSMyAccount web access or any software solution that meets their needs and again, honors all security and privacy requirements. The IRS' role is to facilitate access to the taxpayer's data, not dictate how it is accessed or used by the taxpayer. Empowering consumers with choice encourages competition in the marketplace and ultimately results in better and more robust service offerings—whether it's from the private or public sector.

21. ETAAC recommends that the MyIRSAccount architecture allow solution providers to participate in developing applications that add value to the customer's data. MyIRSAccount is a great start. To the extent the IRS can solve important problems and offer access to the data they need (end-to-end, not just a solution for tax time), more taxpayers will interact and participate in digital IRS tools, including electronic filing. Embracing these recommendations ensures more commercial participants will compete for taxpayers based on the services taxpayers' value. The traditional approach of having one vendor and a single proprietary interface to the taxpayer's data reduces choices and limits solutions and utilization. ETAAC recognizes that the implementation of this recommendation requires strong protections to ensure the security and privacy of the taxpayer's data.